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SUBJECT: Argentine Central Bank Joins Government in Objecting to  
Post's Investment Climate Statement

Ref: Buenos Aires 387

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Summary  
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¶1. (SBU) In an April 6 letter to the Ambassador, Argentine Central Bank (BCRA) President Martin Redrado objected to Post's characterization in the latest Investment Climate Statement of BCRA policies' contribution to rising inflation (text provided below). During a subsequent telephone conversation, Redrado and the Ambassador agreed BCRA economists and Econoffs should discuss ways the Embassy can modify future statements to explain the full range of factors that created the high-inflationary environment between 2006 and 2008. Changing topics, Redrado said he planned to announce the formal currency swap agreement with China the week of April 13. End Summary.

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BCRA: Inflation Not Our Fault  
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¶2. (SBU) In a lucid and well-written April 6 letter to the Ambassador, Redrado objected to the Embassy's assessment of BCRA policies in the recently-published Investment Climate Statement (ICS). He argued that the statement in the ICS that the BCRA "has managed monetary and currency policy in support of the economic expansion, maintaining an undervalued or 'competitive' exchange rate and negative real interest rates," is "a shallow evaluation" of current circumstances. The letter then outlines the arguments that Redrado has made numerous times over the last three years in meetings with USG officials.

¶3. (SBU) Redrado's main points, reported many times in Post cables, are:

- 1) there is "no-one-size-fits-all" policy;
- 2) the small size of the Argentine financial sector limits the BCRA's ability to use monetary transmission channels to control inflation;
- 3) fiscal and wage policies have a more powerful impact on prices (in Argentina);
- 4) monetary policy has gradually become tighter (and increasingly counter-cyclical) in recent years, as reflected by higher interest rates [albeit still negative in real terms];
- 5) a managed float is required in a country where everyone calculates value in dollars and flees the peso at the first sign of trouble; and,
- 6) anti-inflation policy requires coordinated fiscal, wage, competition, and monetary policies. (This last point is his most frequent refrain.)

¶4. (SBU) During a follow-up telephone conversation on April 8, the Ambassador defended the ICS assertions, noting that many prominent local economists agree with our assessment that expansionary monetary policy and an undervalued currency are contributing causes

of high inflation in Argentina in recent years. Nevertheless, the Ambassador agreed that as currently drafted the ICS gives the unfair perception that the BCRA is the main culprit. He also acknowledged the many other contributing factors, and agreed that Post's Econoffs and BCRA economists should meet to discuss ways the Embassy can provide a more complete explanation of the causes of inflation in future statements.

15. (SBU) Redrado responded that the GoA's fiscal and wage policies, in particular, have had an inflationary impact in recent years. He reiterated that the BCRA has sought to pursue counter-cyclical monetary policy, and emphasized that monetary growth over the last year has slowed considerably. Redrado also repeated the request from his letter that the Embassy publish the BCRA letter along with the ICS. The Ambassador explained that this would not be possible, but agreed to include a link to the BCRA website at the end of the ICS (along with other already existing links to other institutions and GoA agencies). Redrado said he would likely publish some form of formal rebuttal on the BCRA site.

16. (SBU) Comment: In our opinion, the inflationary impact of BCRA policies is indisputable, and widely accepted as so among local economists. Nevertheless, Redrado is correct that many other factors -- such as fiscal expansion, rapid wage growth, and high commodity prices -- have played key roles in stimulating consumption and overheating the Argentine economy. Despite its contribution to the excessive expansion of the economy since 2003, there is also no question that the BCRA has played the most responsible policy role of any Argentine institution over the last few years, and continues to be the linchpin keeping the Argentine economy's decline from spinning out of control. Post would argue nonetheless that BCRA monetary policies have tended towards being more pro-cyclical, rather than counter-cyclical, as evidenced by the 25-35% growth in the monetary base in past high-growth years, contrasted with current sub-10% money growth at a time when the economy -- and probably the rate of inflation -- is contracting sharply.

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BCRA-China Swap Coming Soon  
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17. (SBU) Redrado also noted that he will formally announce the currency swap agreement (reported Reftel) between the BCRA and the People's Bank of China (PBC) the week of April 13. (BCRA Vice President Miguel Angel Pesce told Econoff April 13 that the BCRA's Board of Directors formally approved the swap agreement April 8.) Redrado said he sees it exclusively as a contingency "liquidity pool" and downplayed its commercial applications. Explaining the local drama following the PBC's premature announcement of the agreement on March 30, he said he had explained to his counterpart (PBC Governor Zhou Xiaochuan) that he needed to return to Argentina to explain the benefits of the deal and work it through the bureaucracy. Redrado noted the irony that for once it was not the Argentines who leaked the agreement to the press. (Comment: Post's understanding, taken from conversations with official contacts, is that the swap arrangement has a strong commercial focus. Therefore, the Chinese may take exception to Argentine views that its purpose is only to strengthen the BCRA's ability to deal with the ongoing slow-motion run on the peso and help it deal with liquidity crises. End Comment.)

18. (SBU) Begin Text of BCRA President Redrado's letter:

I am writing you regarding the recent publication of the 2009 Investment Climate Statement of Argentina by the U.S. Department of State. In this document, it is stated that "Argentina's Central Bank has managed monetary and currency policy in support of the economic expansion, maintaining an undervalued or "competitive" exchange rate, and negative real interest rates". Unfortunately, this statement unveils a shallow evaluation, which does not consider the objective circumstances under which monetary policy is conducted. The recent global financial crisis shows that there is no "one-size-fits-all" policy and, therefore instruments which are valid for deep and mature credit markets are not available in our country, particularly after the collapse of 2001-2002.

Liquidity and solvency ratios plus the dividend payout exhibited in the last three years shows that the business climate in the monetary

and financial arena is quite healthy; in particular, in a world where government intervention has shown the weakness of the banking sector. The soundness of our monetary and financial system is not a matter of coincidence but the patient and persistent policies followed in the last years. Our strategy entails the pursuance of preventive action to reduce the likelihood of occurrence of adverse shocks or to minimize their potential impact on the economy, including the validity of its four main pillars: (1) a robust monetary policy that ensures the equilibrium between supply and demand in the money market; (2) countercyclical scheme to mitigate vulnerabilities; (3) a managed floating exchange rate regime; (4) a tight regulatory and supervisory framework.

Your assessment of our monetary policy is, therefore, incorrect and inconsistent with the robustness shown in recent years. In a context of an economy that is still in transition towards its long-term equilibrium and where the power of traditional monetary policy instruments is limited, it is mistaken to analyze the monetary policy approach based upon solely on the level of policy rates. Monetary policy must be assessed together with the stance of other policies that affect inflation in a powerful way such as fiscal, wage, income and competition policies.

It is important to understand that, given the history of macroeconomic volatility, fiscal and external dominance and financial crises faced by different emerging market economies, not all countries are at the same stage in the path towards their stable equilibrium. Thus, there are economies approaching their long-term cruising speed in others, however, the convergence is still incipient. In Argentina, despite a notable recovery, several features of the current macroeconomic performance enable us to infer that the economy is still heading towards a new long-term equilibrium. Neither in our history nor in the international experience is it possible to find precedents for the 2001-2002 crisis. Unlike the case of Brazil, Mexico or Southeast Asia, the abandonment of the convertibility regime included simultaneously an institutional breakdown, a huge devaluation, the destruction of the financial system and the default on the public debt. This particular economic history and idiosyncrasy in transition phases not only affects the power of the instrument of the different branches of economic policy but also influences the way economic agents react to incentives and policies. Just to give you an example, economic agents markedly favor, since the crisis, liquid forms of money to the detriment of wider monetary aggregates.

As a consequence, while the traditional role of monetary policy in dealing with inflation is evident in the case of more mature economies where transmission channels (the credit channel, in particular) are deep enough to have a direct impact on aggregate demand, in Argentina monetary transmission channels are weak. Credit to the private sector accounts only for 12% of GDP after reaching levels of about 25% during the nineties. This is also well below the average for Latin America (roughly at 30%). Firms' access to the capital market tends to be restricted. This leads to a low relative effectiveness of the Central Bank's reference interest rate as a tool to manage aggregate demand, and with it, pressures on prices. Therefore, there is no room to take shortcuts: we need to patiently regain the power of the monetary instruments to being able to effectively manage aggregate demand.

Same happens with the exchange rate channel. A managed floating regime that provides predictability for investment, saving and consumption decisions but without providing "exchange rate insurance" is the only possible one at this point in time for Argentina. And this has to do with how our history and devaluations and dollarization has (sic) affected the behavior of economic agents. At any minimum external or domestic turbulence and abrupt adjustments in currency values triggers a significant overreaction with changes in portfolios that take place for precautionary reasons, as opposed to what happens in neighboring countries.

Therefore, the need to prevent a new crisis becomes a priority objective. Under these circumstances, it is imperative to generate buffers and to take into account both macroeconomic and financial stability when conducting monetary policy. While building such a much-needed buffers (foreign reserves accumulation and solvent and highly liquid financial system) that are helping us to weather the international financial crisis today, the commitment of the Central

Banks is to pursue a robust monetary policy through the strict control of the growth of the means of payment.

Monetary aggregates have been growing at diminishing rates since 2004 to stabilize at single digit levels for the trailing 12 months, consistently with the Monetary Program presented every year before Congress, which aims at maintaining the equilibrium between supply and demand in the monetary markets. The strict control of M2 has led to a gradual but persistent increase in interest rates. The control of the growth of M2 is based upon deep sterilization policy that distinguished our current monetary policy from an accommodative (completely passive) monetary policy such as the monetary policy pursued during the Convertibility years. Gradually but in a sustained manner, the stance of monetary policy has been contractive: in the last three years, interest rates managed by the Central Bank, increased significantly.

Moreover, in a still cash-intensive economy, the power of fiscal and wage policy to affect aggregate demand and expectations is significant. Therefore, in making a judgment about expansionary policies, it is critical to track the recent evolution of fiscal and wage policy. During this phase, inflation must be tackled using all the tools of economic policy. In this framework, anti-inflationary policy has to do with joint and coordinated fiscal, wage, competition, and monetary policy actions. It is therefore, not fair to analyze the stance of our monetary policy based upon solely on the level of policy rates. The monetary policy stance must be assessed together with the stance of other policies that affect inflation such as fiscal and wage policies.

To summarize, it is necessary to make a more meticulous analysis to better understand recent inflation process in Argentina. Given our idiosyncrasy, the tools available at this particular stage the Argentine economy is going through, the power of fiscal and income (mainly, wages) policies is key to affect the dynamic of inflation. From the Central Bank we have proved our commitment (with the limited instruments that we have at this point) and we have contributed providing monetary and financial stability given in the framework of an economy that is still in transition to its long-term stable equilibrium.

Please, do not hesitate to contact me should you need further clarification and I look forward to having this letter published at the U.S. Department of State website together with the Statement.

Martin P. Redrado  
Presidente

End Text.

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